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Research Article

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Dependent capitalism and the middle-income trap in Europe na East Central Europe

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Abstract: The post-2008 slowdown in economic convergence by countries of east central Europe towards the level of western Europe is interpreted with the help of a concept of dependent capitalism. Convergence appeared to be rapid up to that year, but then stalled, albeit with differing results depending on the measure used. Dependent capitalism meant that the driver for economic growth comes from inward investment by multinational companies (MNCs). Domestically owned businesses failed when faced with international competition, and their agenda hampers policies supporting an active role from the state. Inward investment is attracted by low wages and has contributed to substantial growth, but the slowdown in investment was accompanied by much slower economic growth and dangers that past investment could turn into a burden on the external balance. The strategies pursued by incoming MNCs have brought areas of upgrading, but frequently leave technological levels somewhat behind those of western Europe. Even where they use the same technologies as in their home countries, wages still remain significantly lower. Achieving full convergence would require a different growth model following a substantial change in economic policies: this does not appear likely in the near future.

Keywords: Eastern Europe, Capitalism, Economic Performance, Dependency
JEL classification: P16, P17, P27

1 Introduction

The aim of this article is to use a version of the varieties of capitalism approach to explain the slowdown in growth in four east central European countries (Czechia, Hungary, Poland, and Slovakia, subsequently central and eastern European countries [CEECs]). A comparative context is provided by additional data from Romania and Germany. The framework is developed from the concept of a dependent economy, which is derived from the theory of dependent development used in relation to some Latin American countries. This, it is argued, has advantages over more common varieties of capitalism approaches as it provides more scope for following the strategies and behavior of different actors and how they interact with each other. This then supports a notion of a variety of capitalism as an evolving and changing entity and makes it possible to follow its prospects for supporting economic development. In this article, the central focus is on three groups of actors: domestically owned business, foreign-owned business, and the state. The last of these responds to pressures and inputs from the first two and also from other social actors. It thereby plays a key role in shaping the environment in which businesses operate.

The key argument in relation to domestic business is that, because of the form it took in the lax political and institutional environments favored by policy makers, it failed when faced with international competition. Domestically owned businesses survived and prospered only when sheltered from such pressures. However, the environment created as domestic business failed, plus policies adopted by

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governments, proved attractive to inward investment from export-oriented multinational companies (MNCs), attracted by cheap labor. Their crucial role in ensuring economic dynamism justifies the use of the term “dependent.” An analysis of the strategies of these companies, using foreign trade data to follow the kinds of products they exported, shows how they brought growth for a time, but not enough to bring convergence to western European levels, raising the question of whether dependent capitalism has not left east central Europe facing what has been described as a middle-income trap.

This is argued, in relation to transition economies as a whole, in the European Bank for Reconstruction and Development (EBRD)’s *Transition Report 2017–2018* [EBRD, 2018, p.7]. The conclusion is that these countries need a “new set of political and economic institutions,” leading to a new growth model that will take them beyond reliance on imported technology. The starting point for this conclusion is the significant slowdown in economic growth across these countries and very noticeably also in CEECs since 2008. However, the existence of a “trap” cannot be proven from evidence of a slowdown alone. It suggests that the current growth model has somehow left, or created, barriers to further growth. These need to be identified to show how far the slowdown may be a short-term phenomenon or how far it is indicative of deeper problems, which may be permanent or which may be surmountable with the help of new government policies. It is for answering these questions that the concept of dependent capitalism is used in this article.

To develop the argument, this article is structured as follows: evidence of a slowdown in growth and in the process of catching up with western European Union (EU) member states is confirmed in the “IS CENTRAL AND EASTERN EUROPE CATCHING UP?” section. The concept of a dependent variety of capitalism and its applicationto CEECs is introduced in the “IS IT DEPENDENT CAPITALISM?” section. The links between the state and domestically owned businesses, showing the limited growth potential of the latter, are covered in the “THE STATE AND DOMESTIC BUSINESS” section. The degree of dependence on incoming MNCs is demonstrated in the “CEEC ECONOMIES’ DEPENDENCE ON INWARD INVESTMENT” section. How these MNCs take advantage of cheap labor in CEECs is demonstrated in the “STRATEGIES OF MNCs” section. Limitations to growth inherent in this variety of capitalism are summarized in the “CONCLUSION” section.

2 Is Central and Eastern Europe catching up?

Comparisons of per capita gross domestic product (GDP), using both nominal levels and purchasing power parity (PPP), are shown in Figures 1 and 2. The starting point in 1991 followed the sharp drop in GDP experienced across the region at the start of its post-socialist transformation. The gap with the EU-15 (pre-2004 EU members) appears enormous at that point and then gradually closed up to 2008. The change is less dramatic when using the PPP measure, but the gap was still significant in 2008, after which catching up by this measure too slowed across the region, albeit less markedly in Poland than in the other countries. The difference in results between the two measures indicates that most of the catching up in nominal per capita GDP was due to changes in price levels, meaning higher inflation or currency revaluation in the CEECs. The difference is also a key factor in the environment in which all businesses operated. Relative levels of per capita GDP were close to relative levels of wages and productivity, so that wages paid by a company in nominal terms were substantially lower than in western Europe, while real productivity levels were much closer. This is a crucial factor in the development of the variety of capitalism in these countries as it made them very attractive to export-oriented MNCs. It remains to be explained why it did not prove a good enough environment for domestically owned firms which should also have been able to benefit from the low-wage levels.

The process of upward convergence towards the EU-15 level, as shown in Figures 1 and 2, shows three fairly distinct stages. The first, the recovery from the depression at the beginning of the economic transformation, continued into the mid- to late 1990s. There were autonomous sources of growth inside the economies, as new private enterprises emerged. A key factor both in the restoration of economic growth and in assuring external balance was a reorientation of former state-owned enterprises, whether still in state ownership or privatized, to exporting simpler products to western Europe. That included raw materials and semi-manufactures that had previously served domestic, or Soviet bloc, users and simpler manufactured goods and components from enterprises that had previously made finished products [Myant and Drahokoupil 2011, Chapter 11]. However, these sources of growth proved to have only a limited potential, and CEEC manufacturers were also undermined by exporters from even lower-wage countries. This was reflected in the slowdown, or even reversal, of upward convergence in some countries by the late 1990s. That marked the end of domestic capital as a basis for international competitiveness in modern manufacturing although, as will be argued, not an end to domestic capitalists in total.

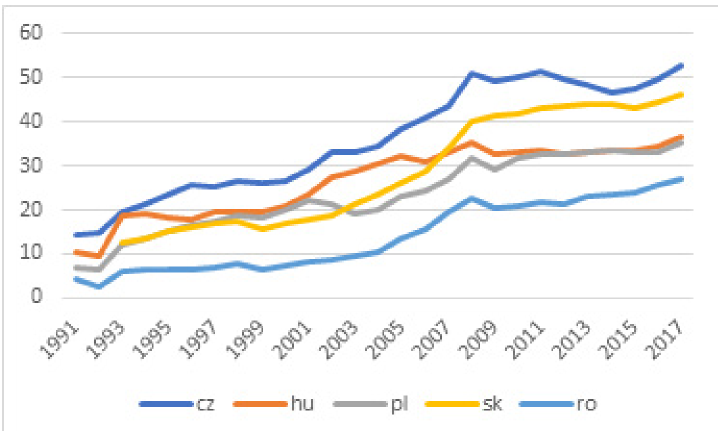

Figure 1. GDP at current prices per head of population, euros, percentage of EU-15. Source: AMECO database, http://ec.europa.eu/economy_finance/ameco/user/serie/ResultSerie.cfm. Abbreviation: GDP, gross domestic product.

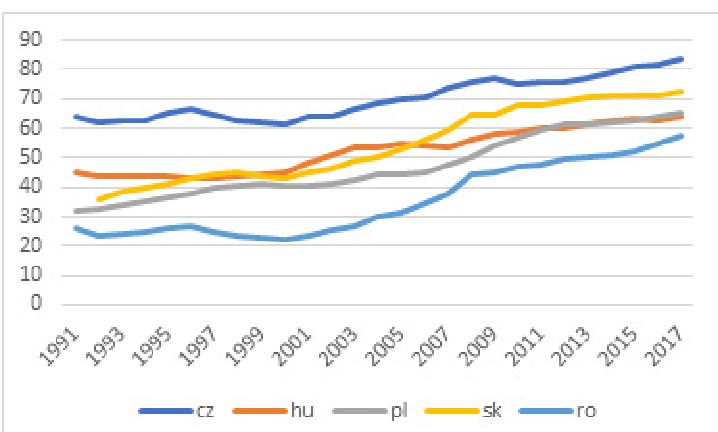

Figure 2. GDP at current prices per head of population, PPP, percentage of EU-15. Source: Figure 1. Abbreviations: GDP, gross domestic product; PPP, purchasing power parity.

The second period, from the mid- to late 1990s up to 2008, was driven by MNCs. Financial inflows associated with bank lending, a prelude to financial instability in 2008 in many other countries, were relatively unimportant in CEECs albeit with some role in Hungary. Countries' financial accounts benefited primarily from inward investment much of which was in export-oriented manufacturing. This brought, as shown in Figures 1 and 2, quite rapid growth, and the associated rising wage levels led to sharp decline for those activities that could no longer compete with cheaper wages elsewhere, notably garment and footwear industries. This was a period of structural change towards reliance on export of more modern manufactured goods. Had the rates of growth from the 2000 to 2008 period continued, then Czechia and Slovakia would have reached the EU-15 level of per capita GDP in 2017 with Hungary and Poland following a few years later.

The third period, from 2008, saw a slowdown, or in some cases temporary reversal, of the catching-up process. This coincided with stagnation in inward foreign direct investment (FDI). However, as shown in Figure 2, this slowdown is less clear when GDP levels are compared by PPP and Poland even did rather well relative to the EU-15 after 2008. There are also signs of renewed growth in some countries after 2015. This confirms that the slowdown indicated in Figure 1 cannot be taken as clear evidence of a permanent trend. Three further points of clarification should be made here on post-2008 development before developing in full the argument that the post-2008 slowdown indicates the possible end of a growth model rather than a temporary blip.

The first is that Polish exceptionalism relates to that country's smaller level of dependence on inward FDI and exports of manufactured goods, as shown in data presented below, and on continued public investment after 2008. The second is that the revival in some countries after 2015 was linked to higher wages, leading to higher domestic demand, and to currency revaluations. The last of these was not a factor for Slovakia, due to that country's membership of the euro area: this contributed to the more stable relationship to the EU-15 GDP level shown in Figure 1 without altering the general trend. The third is that continued growth was helped by EU financial support. The annual rate of net capital transfers in the 2007–2013 period reached 3% of GDP for Hungary and 2% for Czechia, the highest and lowest figures, respectively, for CEECs [ETUI-ETUC, 2017, p.17]. These supported predominantly infrastructure investment, providing an immediate demand stimulus and partially counterbalancing the effect of lower inward FDI. However, this too is only a temporary effect, with declining impact in the EU's 2014–2020 budget period and a likely very substantial decline after 2020. CEECs will have benefited from new physical investment, but there is no evidence of this creating a basis for a new growth model beyond dependence on inward investment by MNCs.

3 Is it dependent capitalism?

The account of CEEC growth performance presented above points to distinct stages with different drivers for growth. Although the post-1989 transformations led to capitalism as normally understood – market economies with predominant private ownership integrated into world markets – it was capitalism that differed in many respects from that of the countries' western neighbors. It also changed over time, and those changes were important to the economies finding new drivers for growth. The question of whether the post-2008 slowdown requires a substantial change in the growth model therefore cannot be answered by extrapolation of past trends but requires an analysis of the effectiveness of past drivers for growth. The recognition that capitalism can take different forms invites application of the varieties of capitalism approaches, although that needs some adaptation from concepts developed with reference to the most advanced economies.

The first difficulty is that, even as descriptive categories, the notions of liberal market economy and coordinated market economy at the core of the Hall and Soskice [2001] approach do not fit with CEEC reality [Lane 2007, Myant 2016]. Most obviously, the level of development of financial systems required for a liberal market economy is absent, as are the cooperative relationships between firms and with trade unions that are at the heart of the notion of a coordinated market economy. These problems are partly overcome with the introduction of a further variety, a dependent market economy, by Nölke and Vliegenthart [2009]. In this version, the CEECs have created environments that give them a competitive advantage in attracting inward FDI by MNCs which then undertake simpler manufacturing tasks in those countries.

However, this still leaves a second problem that varieties of capitalism approaches have tended to provide static, descriptive classifications. They purport to show the basis of competitive advantages in particular kinds of products, but they do not show sources for change and transformation to develop competitive advantages in different kinds of products. Nor do they show forces that may block change, leaving countries potentially unable to catch up with the more advanced in the world. This is particularly relevant to CEECs which have seen very substantial transformations in the recent past and yet still remain some way behind their western neighbors. The challenge for understanding the variety of capitalism is therefore to create a framework that takes account of political and social forces that shape and change that variety.

This leads to a third problem with much of varieties of capitalism literature. Its focus has been on the institutional conditions that lie behind economic competitiveness. However, that focus relates only to part of the form that capitalism may take in an individual country. International integration through FDI was important to maintaining the external balance and to ensuring economic growth, but that leaves considerable flexibility over many features associated with a variety of capitalism, including the level and composition of state spending [Myant and Drahokoupil, 2011, Chapter 16]. It may be argued in the course of political debate that, for example, low taxes and low welfare spending are important to attract inward investment, but evidence for that is thin in relation to the kind of inward investment that has beens important in CEECs, and these levels are determined rather by the balance of internal political forces. A more complete version of a varieties of capitalism approach applicable to CEECs therefore needs to take account of the roles of political and social actors, of the state, and of domestically owned as well as foreign-owned businesses.

This is in line with the concept of "dependent development" applied in a number of Latin American countries in the 1970s [Cardoso and Faletto, 1979; Evans, 1979] according to which dependency does not imply complete subordination to another country and nor does it rule out growth, but the driving force has to come from outside the country. There is still room for important contributions from domestic actors, notably the state and domestic business. The term "dependent" then seems even more applicable for CEECs than for Latin America. Foreign MNCs have been even more important, and any developmental role of the state has been even more restricted. However, the nature and dynamic of the form of capitalism in CEECs cannot be understood with reference to foreign companies alone. As in Latin America, it is the interaction between actors that creates the environment in which they function.

4 The state and domestic business

A class of business owners emerged very rapidly from 1990 but, after an initial spurt, their number increased relatively slowly. Table 1 summarizes the number of employers and self-employed without employees coming close to 4% and 10% of the labor force, approximately the EU average levels. These constituted a significant group of business owners who had considerable political influence, strengthening a particular kind of pro-business political position.

Table 1. Employers and self-employed, as percentage of economically active population, excluding agriculture

	Employers	Employers plus self-employed
Czechia, 1999	3.7	12.9
Hungary, 2004	3.4	12.0
Poland, 2000	3.4	10.5
Slovakia, 2003	2.6	8.7

Source: ILO Laborsta.

Note: Only some years and countries are available for comparison.

Inequality, as shown by Gini coefficients in Table 2, increased significantly after 1990, approaching or passing western European levels which were around 30. As this higher-income group expanded, so too did pressure for a low-tax, small-state agenda. Policies from the early 1990s had been based rather on creating tax and welfare systems closer to western European practice. In 2017, total taxes on income and wealth in CEECs were equivalent to between 7.3% and 7.7% of GDP as opposed to 13.1% for the EU-28, with the highest being 18.9% in Sweden. Romania was even lower at 6.1%. Low taxes on incomes contributed to an overall lower share of government revenues in GDP in CEECs, varying between 33.0% in Slovakia and 38.2% in Hungary [Eurostat, gov_10a_taxag]. Thus, the particular reluctance to tax incomes restricted the scope for welfare spending or for a developmental role for the state.

Table 2. Income inequality, measured by Gini coefficients

	1987–1989	1993–1996	2012–2014
Czechia	19.4	26.6	26.1
Hungary	21.0	27.9	30.6
Poland	26.9	32.7	32.1
Slovakia	19.5	25.8	26.1

Source: World Bank, World Development Indicators, http://data.worldbank.org/indicator/SI.POV.GINI.

Notes: Income inequality appears to be derived from per capita household incomes. Data are not available for every year. Numbers relate to 1 year within the indicated period.

The strength of such thinking contributed to a strengthening neoliberal direction in CEECs from the late 1990s. This roughly coincided with the growing dependence for economic dynamism on incoming MNCs but, paradoxically, its roots were in the consolidation of political life and in the thinking of domestic business which was proving less successful in the international arena. It was also important that countervailing forces were relatively weak: labor had great difficulty making its voice heard and trade unions suffered from an increasingly hostile environment among domestic businesses. That hostility is confirmed from business practices and from survey evidence [Trappmann, et al, 2014]. Trade unions were often better placed in MNCs which came to dominate large-scale manufacturing, a traditional home for organized labor, although even there their bargaining position was weakened by the power of a company with multiple plants across countries. Moreover, labor's position was weakened, and the voice of business enhanced, by an assumption across the political spectrum that business should be given as much help as possible. An influential contribution to the theory of development in CEECs referred to "making capitalism without capitalists" [Eyal, et al, 1998]. In fact, accumulation of wealth was successfully promoted, but the policies adopted meant that, in trying to solve one problem, another was created. The capitalists who were helped were not the kind who could provide dynamism to the economy. The thinking and policy agenda that led to this can be summarized under three points.

The first was a commitment to low taxes on business and on higher personal incomes, accepted across most of the political spectrum. Grzegorz Kołodko, Minister of Finance in Poland's left-dominated government, 1994–1997, illustrated the thinking. He attached great importance to "a capital formation policy" with fiscal preferences for capital gains, reducing corporate and personal income taxes in the hope that this would "enhance corporations' ability to invest and … increase international competitiveness" [Kolodko 2000, p.113]. He accepted that this would lead to greater inequality, but saw all ultimately gaining as he believed it would lead to economic growth.

The second point was a lack of interest in creating a wider institutional and organizational framework for supporting, advising, and financing business development. Private enterprise was seen as just a matter for enterprising individuals responding to market signals. There was no recognition of the need to create and develop frameworks for cooperation between businesses and between businesses and other actors, without which innovation systems cannot take shape. Bodies such as development agencies, common in western Europe, existed in name but with far less meaningful roles, lacking the authority, the financial resources and expertise to promote development [Myant 2009, McMaster 2006]. Empirical evidence shows low levels of coordination between enterprises and also low levels of mutual trust [Jasiecki, 2014a, p.37, Janky and Lengyel, 2014]. This, then, was some way from a coordinated market economy while the limitations of the financial sector, of venture capital and of a research infrastructure, ruled out the model of a liberal market economy.

The third point was a regime of lax regulation and legal controls on business activity including poor or nonexistent protection for minority shareholders, toleration of clear conflicts of interest, and absence of rules to ensure an independent civil service that would hopefully be more resistant to corruption. Much of this was welcomed by parts of the business community – it had helped them accumulate their wealth –

and by politicians who also benefited from links to business. These features were partially and gradually corrected under EU pressure, albeit incomplete and with some reversals, notably in Poland and Hungary from 2016.

The relative failure of domestically owned firms meant that in all CEECs the majority of companies in the region's top 500 were foreign owned with domestically owned private companies below 20% of a country's total in all cases [Jasiecki, 2014b, p.15]. The largest of these often retained substantial state shares and were mostly oriented towards domestic markets (energy, insurance, oil refining) plus a few producers of raw materials. Smaller business empires are typically based on raw materials, media, telecommunications, construction, and chemicals, again with strong domestic market orientations. Successful businesses were in many cases the ones that learned how to take advantage of an environment in which political parties were weak and unstable and quick to welcome unpublicized financial backing from whoever could offer it. That included for a time foreign firms – mostly seeking to buy companies during privatization – and more permanently domestic private business for which investing in political contacts was a key element in their business strategies that could offer a substantial return.

Thus, in Poland, "great fortunes" were created "at the interface of the public and private sectors" [Kowalik, 2011, p.294], helped by close contacts to top politicians. According to one estimate, half of the Polish business elite had contacts with government members [Jasiecki, 2009]. They did not at that time enter politics themselves as their primary ambition was to further their business interests. However, support from politicians is inherently unreliable – politicians change and may also be tempted to favor a rival – so that entering politics directly can be a means to achieve greater security. Such was the likely thinking of Andrej Babiš [Tabery, 2017, Kmenta, 2017], owner of the Czech Agrofert group (ranked at position 274 in terms of sales in top 500 central and eastern European companies in 2017, http://www.cofacecentraleurope.com/News-Publications/Publications/Coface-CEE-Top-500-Companies-2017-edition), and the second richest man in the country. He had built his empire from very little, benefiting, according to information uncovered by investigative journalists [Kmenta, 2017], from foreign contacts going back to the 1980s, from prudent investment in political contacts and from the use of incriminating information on rivals gained from contacts in the police and security services.

His political ambitions appeared when he seemed to be losing political contacts – he had had good helpers within the government dominated by social democrats between 1998 and 2006 – and when some other business groups tried their hands in national politics. In 2012, he created and financed his own political movement *Akce nespokojených občanů* (ANO: action of dissatisfied citizens), and in 2013, as elections were approaching, he added control of a number of key media outlets. Thanks to this power, Babiš's party came second in that parliamentary election and he became Minister of Finance. His party came first in parliamentary elections in 2017, and he was nominated as Prime Minister. Forming a coalition proved difficult as, apart from clear evidence of conflicts of interest in his exercise of a ministerial role, he faced criminal charges for an alleged misuse EU funds. Needless to say, much of his appeal had been built on claims to represent a new start that would eliminate corruption, a theme he could pursue with vigor at least where it concerned his business rivals.

This, it should be added, was not an innovative company and not a world leader in any products or production processes. Its focus was on gaining control over what already existed, with an average of one acquisition per month in the 1996–2006 period [Kmenta, 2017, p.118]. Agrofert exported 23% of its output in 2016, equivalent to 0.1% of total Czech exports (calculated from the company's annual report, http://forum24.cz/wp-content/uploads/2017/07/vyrocni-zprava-agrofert-2016-final.pdf), with the emphasis on standard fertilizers and agricultural products. Babiš's political agenda was not for promoting innovation among other companies, butonly for ensuring low tax levels. Such was the contribution of domestically owned businesses throughout CEECs. In general, they are not innovators, they are low spenders on research and development – lower than foreign-owned companies in their own countries – and an estimate for Czechia showed that they had contributed no significant growth to the economy over the whole 1996–2009 period. Foreign-owned firms had shown sevenfold growth over the same period [Chmelař et al, 2016, p.15]. It is to those foreign-owned firms that we now turn.

5 CEEC economies' dependence on inward investment

MNCs were not significant players in the domestic politics of CEECs. They were rather the beneficiaries of policies decided under the influence of domestic forces and of international agencies and advisers that pressed for liberalization, both within the countries and in international financial relations. This gave MNCs largely what they needed and they quietly accepted such bonuses as low tax burdens. They did press some specific issues, bargaining for the best terms for acquiring enterprises under privatization, when that was their means of entry into a CEEC, and for support to their own investment projects. They pressed, sometimes as groups but often as individual companies, for scope to impose more flexibility in working time, threatening not to invest if labor law did not move in their direction. Overall, however, their political impact was small, in contrast to their economic contribution which was crucial to economic growth.

The inflow of FDI followed slightly different time trajectories, reflecting internal political decisions over whether, and how far, it should be encouraged. Hungary was the pioneer, selling off state-owned enterprises to foreign companies from the start of the 1990s such that inward FDI was already equivalent to 4.3% of GDP in 1991. Others were more reluctant, hoping to be able to rely more on domestic business leaders, but the economic difficulties of the late 1990s led to major reversals in Czechia and Slovakia towards conscious dependence on incoming MNCs. Poland remained more circumspect, retaining a larger share of domestic ownership. Table 3 summarizes the course of inflow of FDI. As the timing was slightly different between countries, no periodization is adequate for all, but the period of maximum inflow roughly corresponds to the period of most rapid growth, as shown in Figures 1 and 2. There were differences in the form taken by FDI. Mergers and acquisitions, mostly privatization but also some acquisition of previously privatized enterprises, were more important in the early years and then in some substantial privatizations of banks and utilities in Czechia and Slovakia in the early 2000s. Nevertheless, in total, this category accounts for only about 25% of total inward FDI for the whole period. The bulk of FDI was in completely new investment. The exact nature of FDI became harder to identify in the last years covered as part of it referred to transfers, including both inflows and substantial outflows, which were more akin to portfolio investment and therefore had no impact on productive potential.

Table 3. Net FDI, as percentage of GDP

	1990–1997	1998–2008	2009–2017
Czechia	2.0	6.3	2.5
Hungary	5.6	5.2	1.4
Poland	1.7	3.5	2.1
Slovakia	3.2	9.0	1.1
Romania	0.9	5.0	2.1

Source: Calculated from http://unctadstat.unctad.org/EN/.

Note: Data for Czechia and Slovakia, 1990–1992, use the same figure for Czechoslovakia for both countries, although proportionately more probably flowed into Czechia.

Abbreviations: FDI, foreign direct investment; GDP, gross domestic product.

The importance of foreign-owned companies within CEEC economies is reflected in stocks of FDI, from the same UNCTAD source as summarized in Table 3, as a percentage of GDP in 2017, which reached 78.3% in Czechia, 74.5% in Hungary, 48.5% in Poland, 58.4% in Slovakia, and 46.55% in Romania. Tables 4 summarizes the importance of MNCs in CEECs for exports in manufacturing and motor vehicles. Shares in value added [Eurostat sbs_na_ind_r2] follow a similar pattern, with a dominant position for foreign ownership in modern manufacturing but a smaller presence in more traditional branches that are less dependent on the most modern technology or which have been less export oriented, such as furniture, garments, and chemicals.

Table 4. Exports from foreign-controlled companies, as percentage of exports from all enterprises, 2016

	All activities	Manufacturing	Motor vehicles
Czechia	51.6	82.5	97.8
Poland	44.4	64.4	90.4
Slovakia	74.8		98.4
Romania	67.6	80.7	93.8

Source: Calculated from Eurostat, ext_tec07. Note: Figures for Slovakia refer to 2014.

The high levels of inward FDI had two immediate positive effects on CEEC economies. The first was to provide a direct stimulus to demand by raising the level of investment in the domestic economy. The second was to help the external balance. In fact, net financial inflows in the period 1993–2008 averaged 4.7% of GDP, the same as average current account deficits in that period. A further point is that FDI carried less risks of financial instability than bank credits as there are no specific repayment obligations. The weight of FDI in countries' financial balances was enormous, such that financial accounts without FDI showed net outflows in several years. In the case of Czechia, the financial account excluding FDI showed a net outflow equivalent to 5.7% of GDP for the period 1997–2007. Hungary was at the other extreme, with considerable inflows of bank credits in the years up to 2008 leaving that country exposed to the direct effects of the financial crisis.

The longer-term positive effect of inward FDI should be in improving the performance of the economy. The benefits can be a direct effect or by encouraging enhanced performance in domestically owned firms. That latter effect has not been clearly demonstrated and is likely to be small, not least because whole sectors are dominated by foreign companies such that any positive spillovers will in turn be to other foreign-owned companies. The direct effect is most visible in the growth and export performance of key sectors, notably motor vehicles. However, much of FDI has also gone into sectors that neither export nor face competition from imports, including banking, utilities, retail, and telecommunications. There could be benefits to the rest of the economy if these activities operate more efficiently under foreign ownership, but that remains difficult to demonstrate.

Table 5 summarizes a long-term danger associated with inward FDI linked to the external balance. Initially, investment is positive for the overall external balance. Over time, the positive effect on the financial account fades and the important effect is repatriation of profits and other outflows to the parent company. This became dominant in the case of Hungary before the other CEECs, such that by 2005–2007 income outflows, equivalent to 5.7% of GDP, were greater than investment inflows, equivalent to 5.2% of GDP. The outflow had not changed much by 2014–2016, as summarized in Table 5, but the inflow had been converted into a net outflow. For a more complete picture, account should also be taken of the exports and imports attributable to foreign-owned companies. Many of these, notably those in retail, are net importers. Manufacturing enterprises are net exporters, and the motor vehicle sector is so important that in its absence there would be net trade deficits from foreign-owned companies in all CEECs for which data are available. In the absence of alternative drivers for growth, the future of these economies would seem to be heavily dependent on the fate of this and similar branches of industry and that depends on the strategies and behavior of MNCs, which is covered in the " STRATEGIES OF MNCs" section.

Table 5. Effects of FDI on external balances, indicators as percentage of GDP, 2014–2016

	FDI inflow	Income outflow	Net exports, whole economy	Net exports, motor vehicles
Czechia	2.6	6.9	2.1	5.2
Hungary	-3.7	6.0	–	
Poland	3.2	3.8	-7.5	6.7
Slovakia	0.2	4.0	5.3	7.1

Source: Calculated from OECD FDI statistics, http://www.oecd.org/corporate/mne/statistics.htm and Eurostat, ext_tec07.

Note: The data in the first two and last two columns are not precisely comparable, using different definitions of FDI. Data for Slovakia under net exports are for 2014 alone. Abbreviations: FDI, foreign direct investment; GDP, gross domestic product; OECD, Organization for Economic Cooperation and Development.

6 Strategies of MNCs

The key attraction for MNCs is the relatively low-wage levels. Table 6 summarizes these compared with the EU-15, including Germany, the source of much of the inward investment. The trend was very similar to that for nominal GDP, as shown in Figure 1. The starting point is set at 1993, being the first year for which the AMECO database provides data for enough countries to be indicative. Pay levels then caught up somewhat up to 1998, by which time FDI inflows had reached substantial levels. Upward convergence to western European levels continued up to 2008 and then slowed or went into reverse. Romania shows consistently lower pay levels, suggesting that on this measure it should be more attractive to inward investment, threatening to undermine the positions of CEEC economies. This is the case only for certain kinds of activities. MNCs also require adequate infrastructure, institutional and legal environments, and labor that is not only low paid but also of adequate skill levels. Romania has not been able to match these requirements for more complex activities.

Table 6. Nominal compensation per employee, 1993–2017, percentage of EU-15 level

	1993	1998	2008	2017
Czechia	11.7	18.4	38.8	40.1
Hungary		19.3	35.8	29.9
Poland	13.0	20.4	31.0	32.2
Slovakia		15.1	32.7	38.8
Romania	5.2	7.8	21.8	24.1
Germany	110.8	104.1	90.8	96.6

Source: Calculated from AMECO database.

The key question for the future of dependent growth in CEECs is whether this upward convergence can be expected to resume, and answering that question requires an understanding of the strategies of MNCs. A substantial literature exists demonstrating cases of outsourcing of simple tasks and of upgrading, ultimately limited by a desire, or need, to keep the most complex activities in companies' home countries [for general discussion and references, see Myant and Drahokoupil 2011, Chapter 15]. There are also very plausible claims from MNCs that they are investing in the very best technology in their CEEC operations. To understand more fully their strategies in taking advantage of low labor costs, a study was undertaken using Eurostat data on labor shares in value added and Comtrade data on exports and imports [Myant 2018a and 2018b]. The first of these sources showed that branches of manufacturing dominated by multinationals in CEECs provide lower labor shares than the same branches in western Europe, but rarely as much lower as would be implied by the difference in pay levels.

The Comtrade data made it possible to calculate kilogram prices for around 20% of the value of CEEC exports. This measure has a long history in the study of state socialist countries, where it was used as an indicator of relative product quality. Thus, the kilogram prices of passenger cars exported, respectively, from Czechoslovakia in 1966 and from Poland in 1981 into the European Economic Community (EEC) were 68% and 63% of the kilogram prices of intra-EEC trade [Myant 1989a, pp.232-5; Myant 1989b, p.3]. The low levels, which fell further in the following years, reflected poor quality of manufacture and increasingly obsolete product design. Those cases were clear, but there are many reservations to relying on the kilogram price measure [Myant 2018a]. Categories need to be as narrowly defined as possible, and there is always some degree of variation in product mix. An export price may reflect expensive and sophisticated imports: this needs to be checked with the use of import data. The measure is also of use only for differentiated products, having most obviously no useful meaning for raw materials.

Using these data, it was possible to identify cases that corresponded to different MNC strategies. There were cases of outsourcing of simpler parts of a manufacturing process, first to CEECs and then to Romania. This happened with wiring systems for transport equipment. There were cases of whole production processes moving to a CEEC, so that a product reaching obsolescence could continue to hold a position in a market. This was the strategy of the Swedish vacuum cleaner manufacturer Electrolux which moved production of established models to Hungary. In both of these cases, the kilogram price fell as production moved, suggesting that the MNC can lower the price thanks to lower-wage costs. There were also cases of exports achieving the same export price from CEECs as from the manufacturer's home country. This was the case with car tires, produced by the German company Continental in, among other countries, Czechia. Remarkably, labor's share in value added in 2015 in the latter country was 18% compared with 72% in Germany, consistent with the lower-wage level simply leading to a higher trading surplus.

The most important case was that of passenger cars, accounting for over 10% of exports from Czechia and Hungary in 2016 and 20% from Slovakia, albeit with a higher level of imported components. Exports from all countries grew rapidly, with and following inward investment. However, as summarized in Table 7, kilogram prices stagnated below the western European level, maintaining a hierarchy that left Romania at the bottom, even falling back in a number of cases and not surpassing the best results achieved under state socialism, as referred to above. This is remarkable when new investment was clearly in the most modern production facilities.

Table 7. Kilogram price of exports of passenger cars, as percentage of German level

	1994	1998	2008	2016
Czechia	38.9	55.2	63.3	60.2
Hungary	13.9	73.6	67.1	73.4
Poland	35.0	47.0	56.1	53.9
Slovakia	4.9	89.2	70.6	64.5
Romania	23.6	45.9	43.8	42.8

Source: Calculated from Comtrade database, https://comtrade.un.org/data.

The explanation does not lie in different quality of products, in the sense of modern design or quality of the manufacturing process. The key is rather that kilogram prices for more expensive vehicles are much higher than the prices for smaller, cheaper vehicles. This applies not only between countries but also within them, such that, at the extreme, vehicles with a petrol engine of over 3,000 cc had an export kilogram price from Germany four times that for those with an engine capacity under 1,000 cc from the same country. High kilogram prices in 1998 from Slovakia and Hungary reflected a balance towards assembly of larger cars. In later years, the values declined as the production of smaller and cheaper vehicles increased. This reflected a clear strategy of MNCs to concentrate such activities in lower-wage countries.

The abovementioned examples show different MNC strategies for taking advantage of cheap labor in CEECs, all of which correspond to the logic of a profit-seeking business. Where possible, simple tasks are relocated into CEECs. This does not provide much help in lifting economies beyond a low-wage, low productivity status. The threat of a move to still lower-wage countries exerts a permanent downward pressure on wages. Moreover, as some of the examples cited above indicate, outsourcing to a low-wage country was frequently followed by a fall in price. This means that measured productivity was also lower, even if the production process was identical to that previously performed in western Europe.

Better long-term prospects should be provided by relocation of complete manufacturing processes for products such as tires and motor vehicles. In the first of these cases, production technology is well established and controlled by a small number of MNCs. There are few innovations, and production does not need close proximity to research and development. An MNC could therefore conceivably transfer production almost in total to CEEC locations, and the Italian company Pirelli has moved in this direction, producing more in Romania than in its home country. In this case, productivity may appear as high as in western Europe, but wage levels remain in line with local practice.

In the case of passenger cars, MNCs face costs when they shift activities into CEECs. They have invested in production facilities and in labor forces in their home countries. There would also be high political costs from a big and visible move into lower-wage countries. In this context, it makes most commercial sense to keep the products that yield the highest value added, being those with the highest kilogram prices, in the highest wage countries. This need not be permanent. It is possible to relocate production of more expensive vehicles, as is shown in some periods by Hungarian and Slovak experience. It could also be profitable to make this move, but the associated costs, and the logic of producing cheaper cars in lower-wage countries, have kept it within such limits as to hold down the average kilogram prices to the levels as summarized in Table 7. In this case too, the lower prices of vehicles made in CEECs lead to a lower level of value added per employee and hence a lower measured productivity level, even if the tasks of production workers may be very similar. Data on labor's shares in value added – 24% in Hungary and 28% in Czechia in compared with 66% in Germany in 2015 [Eurostat, sbs_na_ind_r2] show that wages could increase and still leave substantial profit margins.

7 Conclusion

The countries of east central Europe have experienced slower growth since 2008, and in several cases the gap with western Europe in terms of per capita GDP widened rather than narrowing. The argument in this article is that this can be explained in terms of the variety of capitalism that has emerged in these countries. Domestic business failed as a driver for growth, but has supported a political agenda that limits scope for a developmental role for the state. However, this has created a favorable environment for incoming MNCs that take advantage of cheap labor to produce products for which basic research and development work is undertaken in their home countries. Incoming MNCs offered rapid growth for a time, but not full upward convergence to western European levels. That has not proven possible with a strategy dependent on MNCs.

Alternatives to the current growth model include dependence on domestically owned business and measures to create an environment in which MNCs will undertake higher-level activities in CEECs. The first of these could be a repeat of strategies that failed in the 1990s. There would need to be appropriate policies to create an environment in which those domestically owned firms could compete on the international stage, and that implies substantial support for research and innovation. The two approaches need not be mutually exclusive, depending on similarly daunting changes in approach from policy makers. As MNCs are already more active in research than domestically owned firms, encouraging them to move further would seem an easier task.

Creating an appropriate environment would require, as one element, investment in education, skills, and research. That is limited by constraints on the state budget, in line with the low-tax, low-spend agenda favored, among others, by domestic business. Nor is it an issue pressed by foreign companies for whom existing government policies are broadly satisfactory. In practice, new investment has been dependent on EU funding, with likely reductions after 2020. Moreover, the gap to be overcome is enormous. OECD data show German manufacturing enterprises spending over 9% of value added on research and development in 2014, compared with figures barely over 1% for both foreign and domestically owned firms in Poland and Slovakia, the lowest among CEECs [https://stats.oecd.org/Index.aspx?DataSetCode=AMNE_IN#]. MNCs do undertake some research and development in CEECs, but it is small scale. Transferring substantial research facilities in the hope of establishing a stable and effective research base would appear extremely risky, not least when lower-wage levels and lower levels of public services encourage research workers to seek their futures elsewhere. Establishing effective research bases in CEECs, if possible at all in the foreseeable future, would seem to depend on a stimulus from well-funded public initiatives, with substantial EU-level support.

In the meantime, CEECs will remain dependent economies in which the domestically and foreign-owned spheres complement each other in creating a middle-income trap. The former failed in international competition and hampered support for state activities that could promote research, innovation, and higher skill levels. The latter profited from this environment by using CEECs as a source of cheap labor. The result is a variety of capitalism that has growth potential, but not enough to ensure convergence with western European levels of per capita GDP.

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